Much State Regulatory Ado About Little

Home State Taxation Under the NRRA

By Richard A. Brown

As of July 21, 2011, the Nonadmitted and Reinsurance Reform Act (NRRA), also known as Subtitle B of the Dodd-Frank Wall Street Reform and Consumer Protection Act, reshapes the landscape for state taxation of surplus lines insurance premium.

Under the NRRA, only the home state — the state of the insured's "principal place of business" — may tax surplus lines premium. All other states are expressly preempted (i.e., prohibited) from taxing any portion of it (Section 521(a)). For obvious reasons, every state should update its laws as of July 21, 2011, to tax 100 percent of surplus lines premium where it is the home state; otherwise, substantial amounts of premium will escape tax altogether. (*See "Multi-State Surplus Lines Tax: State Inaction Risks Loss of Surplus Lines Premium Tax Revenue," in Insurance Journal's West Region Jan. 10, 2011 issue, page 20.*)

Compared to the existing patchwork allocation system for taxing multi-state surplus lines premium, home state taxation seems rational and fair. It eliminates the vexing problems and costs surplus line brokers have faced for years trying to comply with conflicting states laws associated with taxation of multi-state surplus lines premium.

Nonetheless, the states appear principally focused on finding a way to preserve the existing system of taxing multi-state surplus lines premium based on an allocation of premium among the various states. To that end, the states are actively pursuing the permitted option under Section 521(b)(1): "The States may enter into a compact or otherwise establish procedures to allocate among the States the premium taxes paid to an insured's home State … ."

Except for fear of uncertainty, there is no obvious reason why the states should invest further time or energy to protect against theoretical loss of surplus lines premium tax revenues attributable to surplus lines policies that insure risks in more than one state. There is even less reason for industry to indulge those fears through interstate compacts or other mechanisms that would directly or indirectly reinstate the same dysfunctional system that home state taxation replaces.

Home State Taxation

Home state taxation eliminates the need for surplus lines brokers to allocate surplus lines premium tax among multiple states. Surplus lines premium tax is paid only to the home state regardless of whether the surplus lines policy insures risks in multiple states.

The term "home state" is generally defined to mean the state in which the insured maintains its principal place of business or where the insured resides in the case of an individual. (Section 527(6) (A) (i)). If 100 percent of the insured risk is located elsewhere, the home state is where the largest percentage of premium is attributed under the insurance contract (Section 527(6) (a) (ii)). For "affiliated groups," the home state is where the named insured member with the largest proportion of premium is located (Section 527(6) (B)).

Effect on Premium Tax Revenues

No one knows with certainty the amount of multi-state surplus lines tax revenues that any given state may gain or lose due to home state taxation. But the amounts involved appear to be relatively insignificant. For example:

- According to the A.M. Best 2010 Special Report "U.S. Surplus Lines – Market Overview," the aggregate direct written surplus lines premium (DPW) for 2009, including Lloyd's, was just under $33 billion.
- Assuming an average nationwide surplus lines tax rate of 4 percent, aggregate surplus lines tax would have been approximately $1.318 billion.
- Divided equally among 50 states, $1.318 bil-

lion would provide each state with $26.36 million of total annual surplus lines tax, only a portion of which is attributable to multi-state placements.

- Although the portion of surplus lines premium for policies insuring risks in more than one state is unknown, knowledgeable industry observers roughly "guesstimate" it at somewhere between 5 percent and 15 percent. On that basis, the amount of surplus lines premium tax for policies insuring multi-state risks would be approximately $1.3 million (at 5 percent) to $3.9 million (at 15 percent) per state.

Some Observations

- For most surplus lines policies, 100 percent of the premium is attributable to risks (a) located in a single state that (b) unquestionably also is the insured's principal place of business by any definition. As applied to such single-state risks, home state taxation should not materially affect the surplus lines premium tax revenues for any one state.
- For multi-state placements, the home state will tax 100 percent of the premium and its sister states 100 percent likewise when they are the home state. Once the home state has taxed 100 percent of multi-state surplus lines premium, it seems politically inconceivable that the home state would agree to then share a portion with sister states, and vice versa.
- Which states will be net winners or losers under home state taxation (and over what period of time) is impossible to predict. The amount of surplus lines premium tax revenues attributable to multi-state placements necessarily is a moving target, depending on whether and to what extent insureds and their principal place of business migrate from state to state (e.g., Boeing's relocation of its headquarters from Washington to Illinois).
- Certain proposed alternatives to home state taxation contemplate a "clearinghouse" that would process all multi-state filings and allocate surplus lines premium tax among the states according to an agreed formula. Query whether the amounts of surplus lines tax involved are sufficient to justify the costs of doing so on a commercially reasonable basis.
- For years the states have been unable to agree on a multi-state surplus lines premium tax allocation method even with the threat of federal intervention. Now that Congress has made the surplus lines premium tax allocation decision for the states, there seems to be even less reason for the states to reach consensus on an alternative premium tax allocation method.

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In conclusion, there is no apparent reason why the states or industry should devote further time or attention to undoing home state taxation or tinkering with possible multi-state surplus lines premium taxation alternatives. Scarce resources would be better applied to resolving the uniformity issues associated with diligent search, surplus lines insurer eligibility, and other surplus lines uniformity requirements mandated by the NRRA.

Until the states comprehensively conform their laws to the NRRA's national uniformity requirements, surplus lines brokers will be in the unenviable position of requiring ongoing legal advice to navigate the uncharted waters of differing state positions regarding the extent to which each state considers its laws preempted. IJ

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